Gifting Strategies in 2011 and 2012

The Window of Opportunity is Closing

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As year-end 2011 fast approaches, we want to provide our Diversified Trust clients and friends with insight into the gifting opportunity created by Congress and contained in The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (''Act''). The Act has created what many in the wealth planning world are calling a ''window of opportunity'' for gifting by individuals. This so called ''window of opportunity'' arises because the Act increased the Federal gift tax exemption from $1 million to $5 million for the years 2011 and 2012. For 2012, the exemption is actually $5,120,000 after being indexed for inflation. In 2013, the federal gift tax exemption is scheduled to decrease to $1 million for gifts made in 2013 or later. Prior to discussing the opportunity for our clients to make large tax free gifts, a review of gifting in general is warranted.

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current environment.

1) **Annual Exclusion Amounts for 2011**

A) Federal = $13,000

B) Tennessee = $13,000 for Class A beneficiaries and $3,000 for Class B beneficiaries. Class A is defined as husband, wife, daughter, son, lineal ancestors, lineal descendants, brother, sister, son-in-law, daughter-in-law and stepchild. Class B is defined as all others.

C) All other states (excluding Connecticut) = No Gift Tax

D) Gift Splitting with Spousal Consent allows $26,000 to be gifted.

2) **Gift must be of a "present interest" to obtain benefit of the Annual Exclusion.** A "present interest" gift is one that may be either vested or contingent and of which the donee/transferee has the immediate use, possession or enjoyment of the interest gifted. When dealing with transfers in trust, the "Crummey" provision allows a gift of a future interest to convert to a gift of a present interest because the beneficiary has the right to withdraw the gifted assets or a portion thereof for a period of time (example 30 days).

3) **Certain transfers are not gifts and are not subject to the gift tax.** Transfers made directly to an educational institution for tuition (not room and board or supplies) are **not** gifts. Transfers for medical expenses including medical insurance premium payments are **not** considered gifts.

4) **Disclaimers are a hybrid form of a tax free gift.** For a disclaimer to be valid, it must be: a) timely filed (i.e., 9 months from date of transfer); b) in writing; and c) filed with the transferor or the transferor's representative. In addition, the transferee cannot accept any of the benefits of the transferred property, and the property being disclaimed must pass to someone other than, and without direction from, the disclaiming beneficiary.

5) **Federal Gift Tax Exemptions.** As set forth above, for 2011 and 2012, the current federal gift tax exemption is $5,000,000 and $5,120,000 respectively. The exemption amount is scheduled to revert back to $1,000,000 on January 1, 2013.

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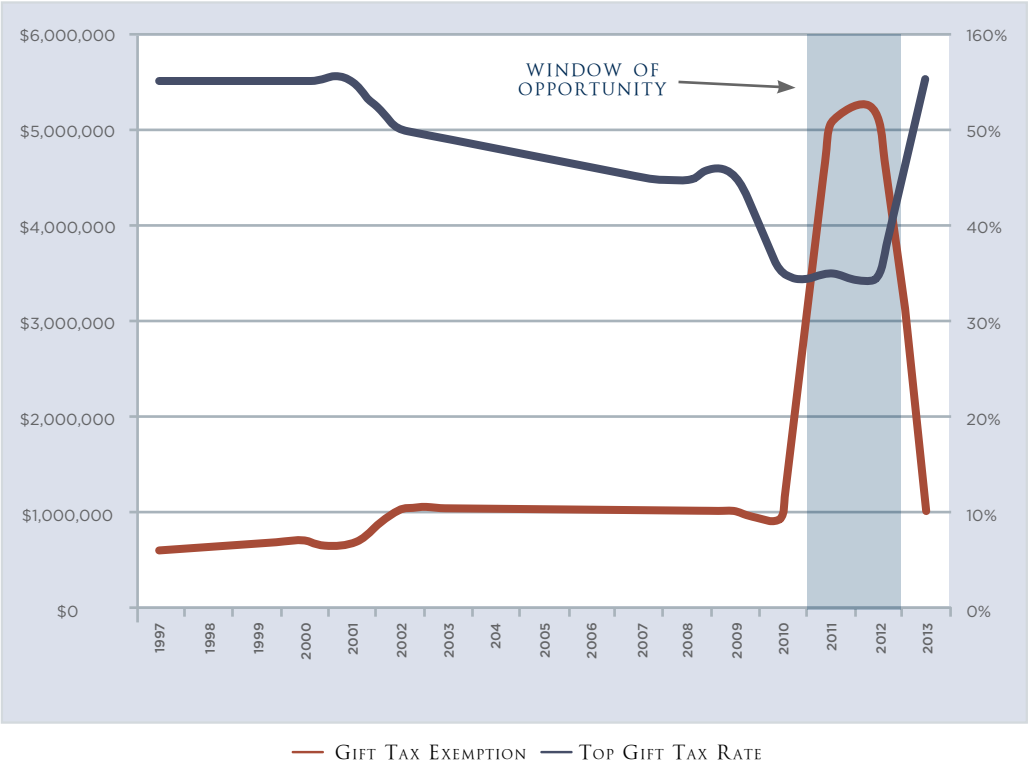
6) **Gift Tax Rates.** For 2011 and 2012 the federal gift tax rate for gifts in excess of the exemption amount is 35%. This rate is scheduled to increase to 55% on January 1, 2013.

7) **Form 709.** This IRS form is utilized by donors to provide information to the Internal Revenue Service regarding the gifts that the individual makes in the applicable calendar year. Only Tennessee and Connecticut are required to file a separate state gift tax return.



gifting in 2011 and 2012.

The Act provides a temporary window to make gifts. Those who have assets which they can comfortably give away should look to take advantage of this opportunity. There are several advantages to gifting. Two examples are:

1) **Reducing the size of your taxable estate.**
2) **You are removing the potential income and appreciation of the gifted assets from your estate**

For instance, suppose your gross estate is valued currently at $6 million and you pass away in 2013 having made only $1 million of gifts prior to January 1, 2013. Based on current law you would owe approximately $2.75 million in estate taxes. If you had made $5 million worth of gifts prior to January 1, 2013, you would owe approximately $550,000 worth of estate taxes. Making the gifts can make a difference.

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who should look at making gifts during this window of opportunity?

Anyone who is comfortable making a gift and can live without the need for the asset which is given away should consider a gift. You may have loaned money to your children and are forgiving the loan over time. This may be the perfect opportunity to accelerate the forgiveness of the loan without federal gift tax consequences. For Tennessee and Connecticut residents, there is the state gift tax to consider. Caveat: When considering your gifting alternatives, do not make gifts that will reduce cash flow beyond your comfort level and needs. The gift should not make you a pauper or dependent upon others. The tax tail should not wag the dog.

what techniques are available to take advantage of this window of opportunity?

One technique to consider is the gifting of a personal residence. Many times a second personal residence (vacation home to most of us) is a candidate for transfer to a **Qualified Personal Residence Trust ("QPRT")**.

A QPRT is an **irrevocable** trust to which a Grantor transfers his or her personal residence or vacation home. Planning pointer: If the personal residence is owned jointly by husband and wife, have each joint owner transfer a 50% interest in the residence to a separate QPRT for his or her benefit. You hedge mortality risk and may even be able to get a discount on the 50% interest conveyed to each separate trust. The Grantor retains the exclusive use of the residence for a term of years as set forth in the trust agreement. If the grantor dies before the trust term is reached, most trust agreements have the residence returned to the Grantor's estate. If the Grantor survives the term of the QPRT, the trust terminates and the residence is either retained in further trust or distributed outright to one or more beneficiaries. If the Grantor desires to occupy the residence after the trust term has terminated, he, she or they can pay fair rental to the new owner of the residence.

The transfer of the residence to the trust is a taxable gift. The amount of the gift is determined using IRS actuarial tables. The amount of the gift is a function of the age of the Grantor, value of the residence contributed to the trust, the term of the trust and the 7520 rate in affect at the time of transfer. Most gifts are less than 50% of the value of the current value of the residence. One can get more discounted value for the gift valuation when 7520 rates are high versus low. However, it can still be beneficial to establish the QPRT if real estate values are low, as they currently are.

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The Grantor has the right during the term of the trust to sell the residence and purchase a new residence. If a new residence is not purchased by the Grantor within two years of the sale of the residence, the trust must then pay an annuity (based on IRS tables) to the Grantor for the balance of the trust term.

If the Grantor dies during the term of the trust, the value of the residence at date of death will be included in the value of the estate of the Grantor as if it had never been transferred. Any gift tax credit taken when the original transfer was made will be restored and any gift tax actually paid will be credited dollar for dollar against the grantor's estate tax liability. Another benefit of the QPRT is that it is approved by the IRS.

Another interesting gifting technique that high net worth individuals might consider, especially during this window of opportunity, is the establishment of a **Dynasty Trust**. With a large gift tax exemption (and GST exemption) and the ability to use discounting (lack of marketability and/or minority interest), it may be the perfect time to transfer non-voting shares of private operating companies to a Dynasty Trust or to transfer units in a limited partnership to a Dynasty Trust. One could also transfer a public equity portfolio to such a trust and remove those assets from the estate tax system for generations or in some jurisdictions forever. As examples, in Tennessee one may structure a trust to run for a term of 360 years and in Delaware, the trust may run in perpetuity. In selecting a jurisdiction for this type of trust, one should also consider the state income tax rules of the jurisdiction to be chosen. Utilizing a jurisdiction which does not tax accumulated income each year acts as an additional gift to the beneficiaries.

When one considers the additional benefits obtained by taking valuation discounts (remember that pigs get fat and hogs get slaughtered), the time to consider such a gift is now. When structuring a trust as a Dynasty Trust, one should consider including a trust protector who has the ability to reform the trust because one cannot know all the circumstances which will arise during the term of the trust.

An additional opportunity may exist for a dynasty trust to buy a significant portion of a client's closely held business. A client could fund the trust with $5 million worth of assets and the trust could execute a note for up to $50 million for the purchase of the closely held interest (for the transaction to be respected, most tax practitioners believe that the trust must have assets equal at least to 10% of the face value of the note). The note would be paid back to the client using the low applicable federal rates (AFRs) that currently exist. A long term note (more than 9 years) executed in November 2011 would have a rate of 2.67% compounded annually. If the purchased asset increases in an amount greater than the

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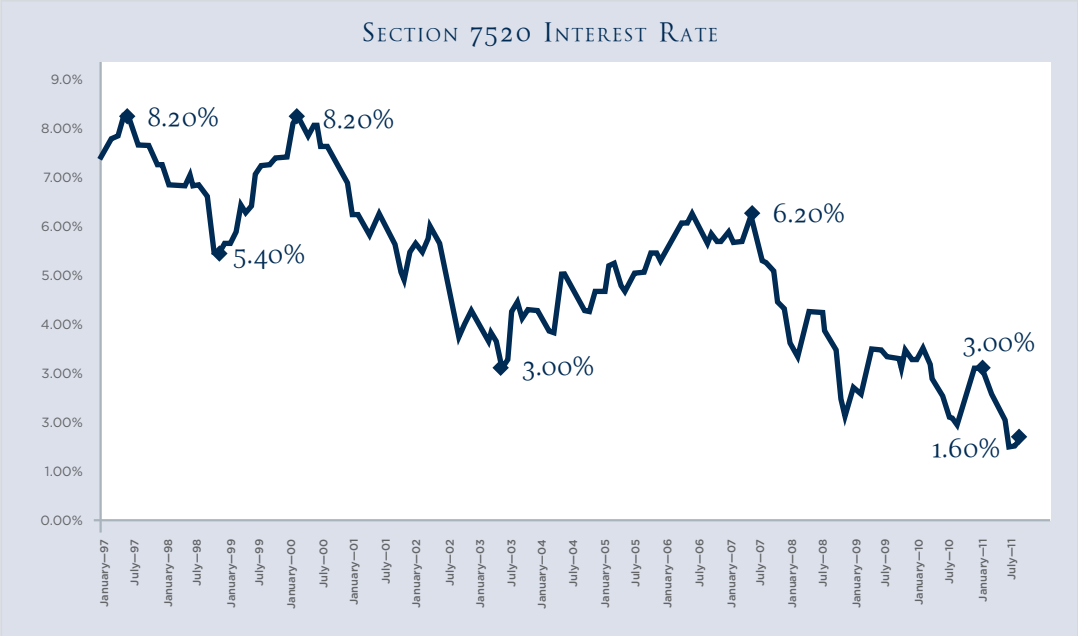
aforementioned rate, then the transaction has worked from a tax perspective. The trust now shelters the assets from the taxing system until the termination of the trust or a distribution of the trust assets.

7520 Rates (Currently Low).

Certain gifting strategies are better suited to be undertaken by a donor in the current Section 7520 low rate environment.

One strategy is that an individual can establish a **grantor retained annuity trust** ("GRAT"). A GRAT is an irrevocable trust which is designed to transfer the **appreciation** on assets contributed to the trust with some, little or no gift tax. The type of asset that one should consider contributing to a GRAT is one that the grantor believes will appreciate significantly over the term of the trust.



The trust will pay the grantor an annuity for a chosen term of years. The annuity is calculated as a percentage of the fair market value of the asset or assets contributed to the trust on the date of transfer. At the termination of the trust, any remaining assets in the trust after the payment of the final annuity payment will pass to the remainder beneficiaries of the trust.

If one wants to avoid making a taxable gift upon funding the GRAT, the GRAT may be "zeroed – out". When a GRAT is zeroed out, the annuity to be paid to the grantor is equal to the present value of the assets contributed to trust on the date of transfer plus the Service's assumed earnings rate (the 7520 rate) on the assets contributed to the trust. In our current economic environment, 7520 rates are historically low, so if an individual has assets that they believe will appreciate significantly during

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the term of the trust then these types of assets should be contributed to the trust. If the donor dies during the term of the GRAT, the remaining trust assets are included in his or her estate. It should be noted that with an increase in the gift tax exemption amount it is not necessary to use a "zeroed-out" GRAT. The increased exemption will cover the gift tax liability and the amount of assets being returned to your estate (in the form of the annuity payments) is much smaller than with a "zeroed-out" GRAT. If you have no remaining gift tax exemption, the zeroed-out GRAT is probably the better approach but remember that the increased size of the annuity payment provides for more assets in your estate.

Since the GRAT is structured as a "grantor trust" for income tax purposes, as grantor, you will be taxed on the income earned by the trust, if any, during its term.

In funding a GRAT, one should consider using assets that are easily capable of valuation and are readily transferable because of the required annuity payment. Assets such as hedge funds and private equity do not provide the flexibility for transfer that stocks, bonds or our common trust fund units provide. As long as valuations are timely, interest in closely held businesses and partnerships are also excellent choices for contributions to GRATs.

A second strategy that you may consider, if you have philanthropic goals, is the creation of a **charitable lead annuity trust** ("CLAT"). A CLAT is an irrevocable trust under which a charitable beneficiary receives an annual annuity payment for a designated term and the non-charitable beneficiaries receive the remainder of the assets held in the trust at the end of the charitable term.

When you establish the CLAT, you will be deemed to have made two gifts: one to charity (the "lead" or income interest) and one to the remainder beneficiaries (the "remainder interest"). The amount of the gift to the remainder beneficiaries equals the difference between the value of the assets contributed to the trust and the present value of the payments to the charitable beneficiary. The present value of the payment to the charity depends upon several factors including the length of the payment term, amount of the payment, frequency of the payments to the charity and the then current 7520 rate. The gift to charity is free from gift tax. The gift of the remainder interest is a taxable gift. With the currently high exemption rate the payment of the gift tax is manageable. If the assets in the trust grow in an amount in excess of the 7520 rate over the term of the annuity

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payment, there should be assets that pass to the remainder beneficiaries. Remember that the assets that are paid out to satisfy the annuity reduce the amount of principal that can earn the excess return.

CLATs can be structured as grantor or non-grantor trusts. If structured as a grantor trust you will receive a charitable income tax deduction but will be taxable on the trust income. The deduction, if large, may have to be spread over more than one tax year. If the CLAT is structured as a non-grantor trust, you do not receive the charitable income tax deduction but are not taxed on trust income. The CLAT is not a tax free entity so it may receive an income tax deduction for the amounts paid to charity since it is taxed on the income earned (this assumes a non-grantor trust).

Another vehicle that a donor can utilize when 7520 rates are high is a **charitable remainder annuity trust** ("CRAT"). A CRAT is a split-interest trust pursuant to which one or more non-charitable beneficiaries receive annual payments for a term certain and one or more charitable beneficiaries receive the remainder of the trust property at the end of the designated term. The term of the trust can be set for a number of years (not to exceed 20) or for the life or lives of the non-charitable beneficiaries. The non-charitable beneficiaries receive the annuity payment for the designated term.

The two tax benefits associated with a gift to a CRAT are that the donor can receive a charitable income tax deduction upon the funding of the trust (deduction equals the difference between the present value of assets contributed and the present value of the annuity interest based on the IRS rates, the payout rate and the term of the trust). The second benefit of the trust is that it is not subject to income tax. Even though the trust is tax- exempt, the non-charitable beneficiary will be taxed on the income earned by the trust based on a tier system. The annuity payments are first deemed to be made from ordinary income (including undistributed income from prior years), then capital gains (including undistributed income from prior years), then tax-exempt income and finally from principal.

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Important Notes And Disclosures

additional gifting considerations.

1) Taking into consideration again that only Tennessee and Connecticut have a state gift tax, if a Tennessee resident makes a gift using the $5 million exemption, it will cost the individual approximately $463,000 in Tennessee gift tax. One might consider changing their state of residence to another state which does not have a gift tax or have a spouse change residency and have the non-resident spouse make the gift.

2) When considering a gift, discuss the use of trusts versus outright gifts because of issues such as divorce, creditors or poor fiscal management which may be applicable to the donee.

3) The Tennessee gift tax will not apply to a gift of real estate or tangible personal property that is located in another state. Think of vacation homes in other states and the use of the QPRT.

4) A donor should have adequate assets to provide cash flow to maintain his or her living standard. Do not give it all away and be dependent on others.

5) Not all gifts are created equal. Some gifting vehicles, like GRATs and CRATs return a portion of the principal back to the donor.

Contact us if you have questions or want to discuss other opportunities to make gifts or structure your estate so it matches your goals. Please note this window of opportunity could change prior to December 31, 2012, if Congress acts sooner. Please consult your own tax professional or attorney for specific advice. This paper is intended to be educational in nature, as individual circumstances may vary. ■

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